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IMF's Loan and its Implications on Bangladesh Economy

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Economic Policy Unit
Unnayan Onneshan

IMF's Loan and its Implications on Bangladesh Economy

Bangladesh is negotiating a credit deal with the International Monetary Fund (IMF) equivalent to USD one billion under its Extended Credit Facilities (ECF) program for three years. The ECF would replace the Poverty Reduction and Growth Facility (PRGF) under which medium term financial support is provided to countries with persistent balance of payments problems. The replacement of ECF hardly changed any substantive policies, terms and maturity date as those were under the PRGF.

The IMF standby loans are provided to its members basically to maintain the balance of payments difficulties usually on the basis of strict adherence to stipulated corrective measures. The credit facility endorsed by the IMF is quite similar to that of the World Bank accompanied by a set of conditions which might go against the interest of the debtor countries. The archetypal prerequisites for IMF credit facility are privatization, trade liberalization, and increase of interest rate as well as reduction of subsidy in oil prices. These conditions are attached for the interests of the major IMF shareholders but might be counterproductive for the debtors' economy in the long run. This issue of the Bangladesh Economic Update investigates the conditions of IMF's one billion dollars loan and its implications in the economy of Bangladesh.

Conditions of IMF's USD one billion loan to Bangladesh:

1. Pursuing a contractionary monetary policy in order to check inflationary pressure.
2. Further liberalization of tariff level
3. More liberal exchange regime by moving into floating exchange rate regime.
4. Privatization of the loss making SOE's in order to create more efficiency and more competencies.
5. Placing new VAT and income tax in order to achieve revenue targets.
6. Phasing out bank lending rate ceilings (for bringing in greater flexibility in the lending regime).
7. Raising CNG and furnace oil prices.
8. Introducing a debt management strategy to reduce budget deficit.
9. Plan to streamline the ADP project approval and implementation process.
10. Develop a new auction mechanism for government paper.
11. Complete audits of SCBs accounts for the year 2010 using internationally affiliated reputed auditor.

1. Contractionary Monetary Policy

The IMF advocated Bangladesh to pursue a tight monetary policy assuming that the country is facing inflation which is demand pull in nature. In reality, inflation takes place in Bangladesh due to supply shock.

Contractionary monetary policy[1] is one of the major conditions set for negotiating IMF's USD one billion loan under its Extended Credit Facility (ECF) programme. As stated by the IMF, Bangladesh has to pursue a tight monetary and fiscal policy to control its inflationary pressure. It is necessary to mention that IMF fell short to identify the real phenomenon of Bangladesh's inflationary situation. The IMF advocated Bangladesh to pursue a tight monetary policy assuming that the country is facing inflation which is demand pull in nature. In reality, inflation takes place in Bangladesh due to supply shock. As IMF got it wrong in the first hand to analyse the inflationary situation in Bangladesh, it went on to advocate tight monetary policy for Bangladesh to check inflation. In Bangladesh, inflation, especially food inflation is skyrocketing mainly for the shortage of supply of the basic food items in the local market as well as for supply shock inflation prevailing in the global market. To control supply shock inflation, augmenting the level of production can be an effective step along

[1] Contractionary monetary policy is monetary policy that seeks to reduce the size of the money supply. In most nations, monetary policy is controlled by either a central bank or a finance ministry.

with other necessary measures. On the other hand, tight monetary policies in demand pull inflation might create a reverse effect by soaring up inflation further and increasing the balance of payment pressure.

The tools used by the Bangladesh Bank to control the money supply are discount rate, Required Reserve Ratio and open market operation as advised by IMF.

The objective of the monetary policy is to influence the performance of the economy which is supposed to be reflected in inflation, economic growth and level of employment. The tools used by the Bangladesh Bank to control the money supply are discount rate, Required Reserve Ratio and open market operation as advised by IMF. Adopting a tight monetary policy would reduce the availability of credit to the commercial bank and its ultimate effect will be the reduction of credit availability to the people which would cause an increase in interest rate.

2. Impact on Savings

Bangladesh bank has recently raised the Statuary Liquidity Ratio (SLR), Cash Reserve Ratio (CRR) as well as removing the lending interest cap as a major requirement under IMF's USD one billion loan.

Bangladesh Bank has recently taken steps to remove the interest rate ceiling to allow the commercial banks to move into the market based rates. The major argument to remove the lending rate cap on interest rate is to provide a remedy to financial sector for a massive liquidity crisis in the financial market. In fact, Bangladesh bank has recently raised the Statuary Liquidity Ratio (SLR), Cash Reserve Ratio (CRR) as well as removing the lending interest cap as a major requirement under IMF's USD one billion loan. The lending rate cap removed from the areas includes commercial credit, working capital, housing loan and loan to non-bank financial institution. The effect of transforming the interest rates into the market based rates might have a counterproductive effect on the overall performance of macro economy.

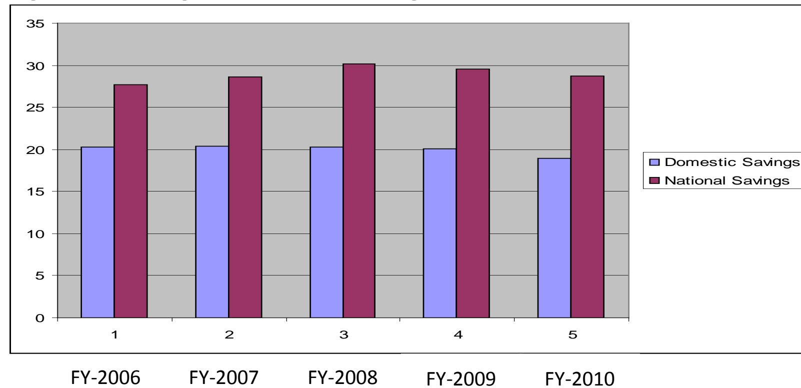
In 2009, Bangladesh bank imposed the maximum limit of interest rate at 13 percent in an effort to boost investment.

The higher lending interest rate and the discrimination of charging interest rate among various commercial banks obliterated the level of investment in Bangladesh. In 2009, Bangladesh bank imposed the maximum limit of interest rate at 13 percent in an effort to boost investment. The interest rate ceiling was much lower than the market based interest rate. The policies of interest rate ceiling initiated during that period succeeded to achieve its ultimate goal in raising investment volume, employment and per capita GDP.

Removal of ceiling in interest rate is expected to have an impact in the interest rate to amplify. The deposit interest rate rises at a lower rate than that of the lending interest rate. Even though the deposit interest rate had a positive impact on savings, it was observed that

the savings did not rise correspondingly with deposit interest rate during FY 2010. This was because the expenditure on foods rose at a greater pace while the income level rose steadily.

Figure 1: Savings GDP ratio in Bangladesh



Source: BBS and Bangladesh Bank

Table 1: Savings as a percent of GDP in Bangladesh

Year	Private Savings	Public Savings	Domestic Savings	National Savings
2006	18.84	1.41	20.25	27.67
2007	18.94	1.41	20.35	28.66
2008	18.96	1.35	20.31	30.21
2009	18.77	1.32	20.09	29.57
2010	17.72	1.27	18.99	28.75

Source: BBS and Bangladesh Bank.

The gross domestic savings as share of GDP declined from 20.31 percent in FY 2008 to 18.99 percent in FY 2010. Moreover, public and private sector savings also declined in FY 2010.

The gross domestic savings as share of GDP declined from 20.31 percent in FY 2008 to 18.99 percent in FY 2010 (Table 1). During the same time period a decline was observed both in public and private sector savings. Private sector savings in GDP also dropped slightly from 18.96 percent to 17.72 percent from FY 2008 to 2010 respectively. This was mainly due to higher consumption expenditure. The ratio of public savings declined from 1.35 percent in FY 2008 to 1.27 percent in FY 2010. This attributes to the higher revenue expenditure over revenue earnings incurred by state owned financial and non-financial institution.

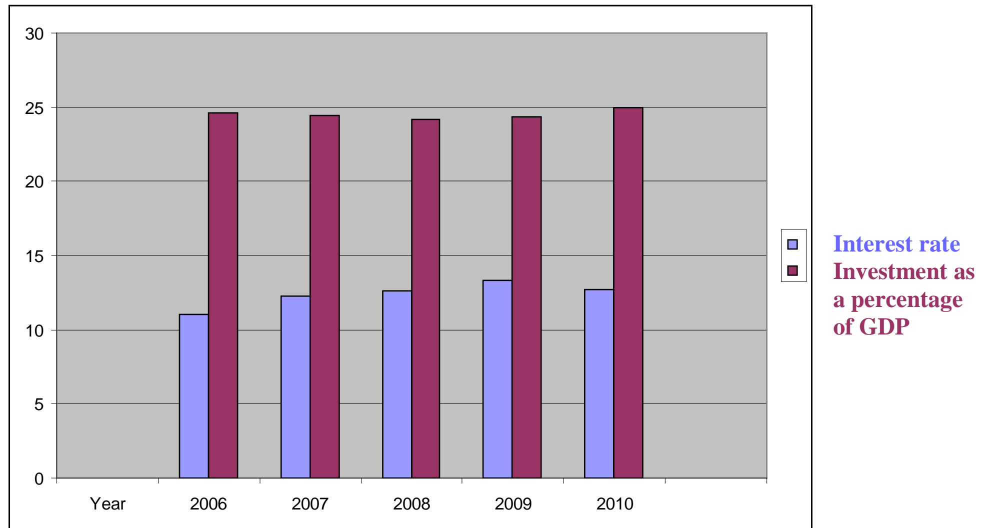
The recent initiative of Bangladesh Bank to remove the interest rate ceiling might have an adverse impact on investment. The reduction in investment volume is likely to put pressure over the national output that may reduce the employment rate in the country. A decline in employment rate might reduce the income level. On the other hand, reduction of output will create supply

shock in the domestic market that will ultimately increase the inflation rate. Therefore, the combined effect of reduction in income level and an increasing inflationary pressure is likely to cause a drastic reduction in savings.

3. Impact on Investment

The level of investment in a firm or economy is inversely related to interest rate. As the ceiling of lending interest rate has been removed it will increase the lending interest rate. This higher interest rate in real terms will have an adverse impact on investment. If corrective measures are not taken, it is likely to worsen the existing low investment phenomenon in Bangladesh.

Figure 2: Interest rate and Investment GDP Ratio in Bangladesh.



Source: BBS and Bangladesh Bank

Table 2: Interest Rate and Investment Relationship in Bangladesh

Year	Lending Interest Rate	Deposit Interest Rate	Total Investment as a Percentage of GDP
2006	11.06	5.77	24.65
2007	12.28	6.51	24.46
2008	12.63	7.23	24.21
2009	13.36	7.97	24.37
2010	12.75	7.34	24.96

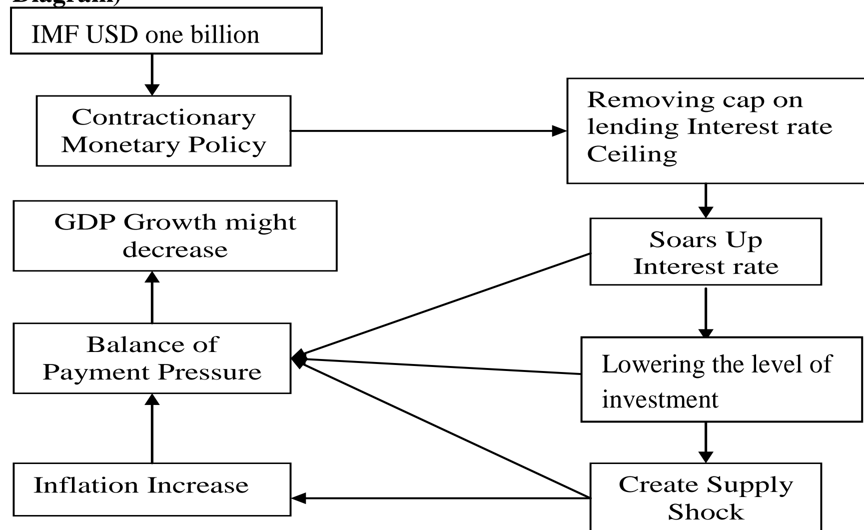
Source: Bangladesh Bank and BBS

During FY 2006, the lending interest rate was 11.06 percent and the total investment ratio in GDP was 24.65 percent. The lending interest rate shot up from 11.06 percent in FY 2006 to 12.28 percent in FY 2007. A declining trend of investment was observed

Due to the existence of ceiling till FY 2010, the share of investment in GDP continued to rise from 24.37 percent in FY 2009 to 24.96 percent in FY 2010 while the lending rate of interest started to decline from 13.36 percent to 12.75 percent from FY 2009 to FY 2010 respectively.

in GDP as the investment falls from 24.65 percent in 2006 to 24.46 percent in 2007. Between FY 2007 and 2008, the lending interest rate rose from 12.28 percent to 12.63 percent and investment ratio in GDP declined from 24.46 percent to 24.21 percent in the same period. In 2009, the Bangladesh Bank has imposed a 13 percent interest rate cap on commercial banks' lending in order to boost industrial growth. Despite the rise in lending rate of interest during FY 2008 to 2009 rose from 12.63 percent to 13.36 percent respectively, the total investment as percentage of GDP rose from 24.21 percent to 24.37 percent respectively. As the ceiling existed till FY 2010, the share of investment in GDP continued to rise from 24.37 percent in FY 2009 to 24.96 percent in FY 2010 while the lending rate of interest started to decline from 13.36 percent to 12.75 percent from FY 2009 to FY 2010 respectively.

Figure 3: Effect of Contractionary Monetary Policy (A Circular Flow Diagram)



It has been demonstrated in the past few years that both the lending and deposit interest rates are rising. It was also observed that lending interest rate was rising at a higher rate than the deposit interest rate. The cost of doing business will increase significantly if the cap on interest rate ceiling is removed that would ultimately reduce the volume of investment. The level of investment is positively related to the GDP growth. Thus the reduction of investment would cause a negative impact on the level of production which might increase the supply shortage of output. On the other hand, the purchasing power of the people will continue to decrease as the food inflation has maintained a rising trend. So the dual effect of reduction in national output and savings with an

increasing the interest rate and unemployment might soar up the general inflation rate further. This would also create a serious austerity over the government to achieve a GDP growth rate of 10.7 percent in 2017 which was mentioned in the election manifesto of Awami League.

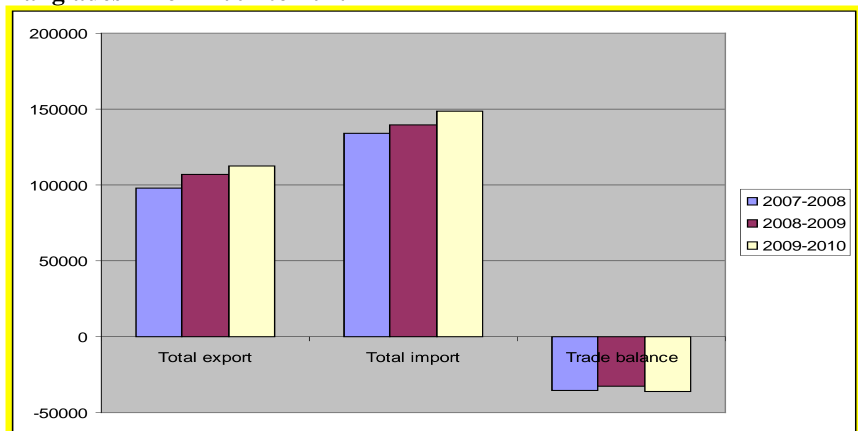
4. Liberalization of Tariff Level

Further liberalization of trade regime by reducing tariff rate and removing trade barriers are the major requirements for Bangladesh for receiving IMF's loan under the Extended Credit Facility (ECF) programme.

4.1 Trade liberalization enhances trade deficit

The removal of both import and export duty generally puts pressure for both import and export of the country. The benefit of tariff removal depends on the economic strength and nature of economy of the particular country. Bangladesh is particularly an import dependent country. The liberalization of trade would reduce per unit import cost but the quantity of import is likely to increase which would eventually amplify the overall import volume. At the same time, the removal of export duty would also augment the export volume. But the total import cost may outweigh the total export earnings that would ultimately lead to a greater degree of trade deficit.

Figure 4: Total Export Import and Trade balance Relationship in Bangladesh from 2007 to 2010



Source: Bangladesh Bank

Table 3: Cost of export, import, and trade balance. (Taka in core)

Fiscal year	Total export	Total import	Trade balance
2007-2008	98160.0	133794.3	-35634.3
2008-2009	106999.7	139588.5	-32588.8
2009-2010	112305.1	148550.8	-36245.7

Source: Bangladesh Bank

During FY 2009-2010, the value of total export was112305.1 crore taka and the total import was BDT 148550.8 crore where the trade deficit was BDT 36245.7 crore.

During FY 2007-2008 the total export was BDT 98160.0 core (taka) and the total import was 133794.3 crore Taka while the trade deficit was 35634.3 core. In the FY 2008-2009 the total export was BDT 106999.7 crore and the total import cost was BDT 139588.5 core whereas the trade deficit stood at BDT 32588.8 core.

During the period of FY 2009-2010, the value of total export was112305.1 crore taka and the total import was BDT 148550.8 crore where the trade deficit was BDT 36245.7 crore in the mentioned period.

It is quite evident that both the export and import is on rising trend in each fiscal year. But increasing rate of import cost is much higher than the export earnings and consequently causing a huge trade deficit every year.

Table 4: Value of Export and Import from July to November, 2010 (Taka in core)

Month	Export	Import	Trade Balance
July	12669.7	13545.6	-875.9
August	12516.2	15230.2	-2714.0
September	9865.3	15302.3	-5437.0
October	11949.6	13557.1	-1607.5
November	10971.6	17135.4	-6163.8

Source: Bangladesh Bank

In July 2010, trade deficit was BDT 875.9 crore and the trade deficit stood at BDT 1607.5 crore in September 2010.

In July 2010, the export and import balance was 12669.7 and 13545.6 core taka and trade deficit was BDT 875.9 crore. During the month of August export, import and trade deficit were 12516.2, 15230.2 and 2714.0 crore taka respectively. While in September export and import value was 9865.9 and 15302.3 crore taka and the trade deficit stood at BDT 1607.5 crore at the same time period. It was observed that during the period of July to September, trade deficit was increasing.

Since Bangladesh is an import dependent country, the liberalization of trade would increase trade deficit. If further tariff liberalization takes place as per the IMF prescription, it would be

difficult for the Government to maintain the present GDP growth rate.

4.2 Liberalization of tariff level might hamper local industries

Trade liberalization would lessen the Government's authority to intervene into the market mechanisms.

Trade liberalization would lessen the Government's authority to intervene into the market mechanisms. If both the export and import duties are fully liberalized, the goods and services of other countries will enter into the local market quite easily. Since Bangladesh has a huge trade deficit with its trade partners, IMF argued that trade liberalization would boost the country's export hence reducing the trade deficit.

The negative impact of tariff liberalization in Bangladesh would offset the positive outcome. Given that Bangladesh is an import oriented country, further liberalization of the tariff level would hamper the local industries to grow.

Lifting of export and import restrictions would push Bangladesh tilted toward the free market economy. Further liberalization of trade regime might pave the way for foreign goods and services to enter into the local market that would force local industries to face a tough competition with the highly subsidized products of India, China, U.S.A. and Malaysia.

Unemployment would rise in Bangladesh if mechanisms to protect the local industries are not in place. Among the local industries which would face the threat of extinction due to trade liberalization are sugar, cotton and woven industries. In the recent past, Bangladesh has produced 90% of sugar of its total demand. Further trade liberalization would pave the way for Indian sugar to take control of the local market. Nowadays, Bangladesh imports almost 50% of its sugar from India that bears the testimony of trade liberalization.

The cotton and weaving industries in Bangladesh were in a very strong position as these had a huge demand in the local market as a backward linkage industry of the Ready Made Garments (RMG). Currently, the Bangladeshi cotton and weaving industries are on the brink of collapse as the Indian cotton is replacing the local industry. In fact, this trade liberalization caused 'dumping' in the local market. If further tariff liberalization takes place as per the

IMF prescription, it would be difficult for the Government to maintain the present GDP growth rate.

5. Deregulation of Exchange Rate and the Performance of Macro-Economy

The International Monetary Fund (IMF) is stressing Bangladesh to change its current managed floating exchange rate system and move to clean floating exchange rate system where the exchange rate of taka will be determined by the interaction of demand and supply of taka in the foreign exchange market.

It is normally believed that the floating exchange rate system enhances the possibility of currency depreciation. In fact, adopting a floating exchange rate system doesn't necessarily mean that the currency will be depreciated. Currency might appreciate or depreciate, depending on the nature of the country's trade balance. Demand of the currency is usually higher than the supply in an export driven economy which leads to the appreciation of the currency. Consequently, floating exchange rate would lead to currency depreciation in an import based country like Bangladesh.

It has been noticed that the currency depreciation has taken place in Bangladesh over the years as a result of adopting flexible exchange rate gradually.

Table 5: Exchange rate of currency from 2004-2005 to 2010-2011

Time Period	Exchange rate
2004-05	61.39
2005-06	67.39
2006-07	69.03
2007-08	68.60
2008-09	68.80
2009-10	69.19
2010-11	71.036

Source: Bangladesh Economic Review, Bangladesh Bank

Table 6: Percentage change of depreciation of BDT against USD during FY 2005-06 to FY 2010-11

Time Period	Percentage Depreciation of BDT against $USD
2005-2006	9.25
2006-2007	2.92
2007-2008	-0.62
2008-2009	0.29
2009-2010	0.56
2010-2011	2.66

Source: Authors' calculation from Bangladesh Economic Review, Bangladesh Bank

The depreciation continued from the FY2009-10 to FY 2010-11 by 0.56 percent and 2.66 percent respectively.

During the FY 2004 – 05, the exchange rate was 61.39 and in FY 2005 – 06 it was 67.39 with a 9.25 percent depreciation of BDT against USD during the same period of time. In FY 2007-08, the exchange rate was 68.60 appreciating 0.62 percent of BDT against USD compared to the previous year as a result of global recession. During FY2008-09, the exchange rate was 68.80 and in FY 2009-10 it was 69.19 meaning a BDT depreciation of 0.29 percent from FY2007-8 to FY 2008-09. The depreciation continued from the FY2009-10 to FY 2010-11 by 0.56 percent and 2.66 percent respectively.

5.1 Continuous currency depreciation may stimulate the inflationary pressure in Bangladesh

Being an import oriented country, Bangladesh may might face difficulties as its import cost would be stimulated further as a result of currency depreciation. This higher cost of import may eventually soar up the price level in the domestic market.

Bangladesh earns a sizable amount of foreign exchange by exporting some specific products such as - readymade garments, leather, shrimp, jute, medicine and recently from ship industry. If the currency depreciates further the earnings from exporting goods and services would augment which prompts domestic exporters to export more. This tendency might create supply shock in the domestic market causing in price level rise.

5.2 Depreciation of taka and its effect on trade deficit

In theory, exchange rate depreciation increases export and reduces import. But in the case of Bangladesh, trade deficit increases when currency depreciates since price effect will dominate the value of import. In other words, the higher cost of imports will offset the reduced volume of imports.

Marshall Learner's 'J' curve depicts that a decline in the value of home currency against foreign currency should be followed by a temporary worsening in the trade deficit before its longer term improvement.

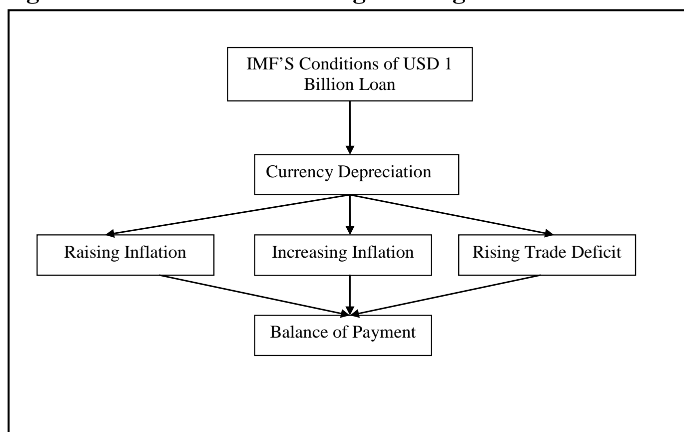
There is a 39 percent increase of trade deficit between July to November of FY 2009-10 and FY 2010-11.

Table: Trade deficit of the time period July to November 2010 and July to November 2011

Time Period	Trade Deficit
July to November FY 2009-10	197.6
July to November FY 2010-11	274.6

There is a 39 percent increase of trade deficit between July to November of FY 2009-10 and FY 2010-11. Besides the tariff structure, bilateral negotiations between two countries, many non-tariff barriers and many other factors might play a role behind trade deficit. But the currency depreciation is one of major component that can put a considerable effect on trade deficit. Thus, currency depreciation raises trade deficit and inflation which affects the balance of payment of a country.

Figure 5: The Effects of floating exchange rate on Balance of Payment



5.3 Capital account convertibility

The term capital account convertibility refers to an uninterrupted movement of capital assets from one country to another at a market determined exchange rate. Capital account convertibility is a feature of a nation's financial regime that centres on the ability to conduct transactions of local financial assets freely at a market determined exchange rate (Wikipedia). In the words of Legmen, it is basically a policy that allows the easy exchange of local currency for foreign currency at a low rate.

5.3.1 Pure Floating Exchange Rate and Capital Convertibility in Bangladesh

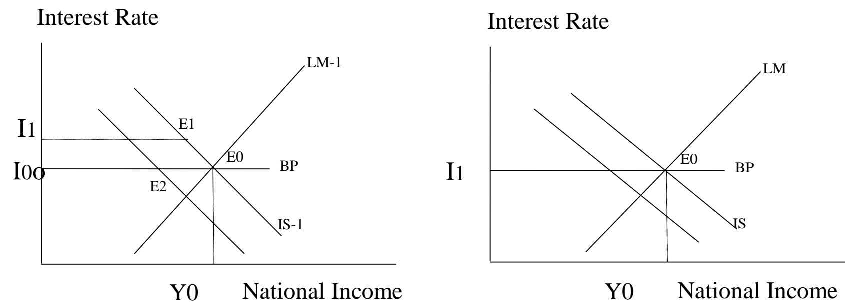
Capital account convertibility is one of the major tools of developed countries to attract the foreign investment into local market. From the context of Bangladesh, the full capital convertibility with clean floating exchange rate might be an erroneous policy right now. Under the clean floating exchange rate system and under perfect capital mobility there might arise the subsequent penalties.

- A huge amount of domestic savings might be shifted to other countries
- Very highly capitalized foreign banks and profit maximizing multinational companies will enter and can create an unequal playing field.
- The economy is likely to face an extreme volatility under the perfect capital convertibility by inviting 'hot money' into the country.

5.3.2 Capital convertibility under floating exchange rate regime likely to create capital outflow

The exchange rate system, capital mobility and interest rate are three very sensitive elements for any country's macroeconomic policy perspective. Any mismatch in the policy making in terms of these three macroeconomic variables might break the macroeconomic backbone of a country as has been observed in the Asian financial crisis in 1997. Professor Mundell and Fleming has shown the effects of monetary and fiscal policy in an open economy under the perfect and imperfect capital mobility. According to Mundell-Fleming model, the monetary policy would be effective in floating exchange rate system and fiscal policy would be useful under the fixed exchange rate regime.

Figure 6: Effects of contractionary monetary and fiscal policy under floating exchange rate regime in perfect mobile capita (Mundell Fleming Model)



Bangladesh is required to adopt a contractionary monetary policy by reducing money supply and raising interest rate and to pursue a contractionary fiscal policy by raising the income tax and VAT as well as reducing the government expenditure for receiving the 1 billion dollar loan from IMF.

Under the floating exchange rate regime, if Bangladesh Bank pursues a contractionary monetary policy the LM curve would shift to the left causing increase in interest rate which would allow a huge capital inflow in the country. At the same time, BDT will be appreciated that might create a more export competitive atmosphere, as a result interest rate would be high which would reduce the aggregate demand through reducing investment. This would cause a reduction in interest rate. With the reduction in interest rate, there will be a significant amount of capital outflow from the country.

According to Mundell Fleming model, if Bangladesh initiates both contractionary monetary and fiscal policy by adopting pure floating exchange rate system, there might be a huge capital outflow from Bangladesh that will dampen savings and there would be an adverse impact over the local manufacturing industries due to declining investment. Consequently, IMF’s conditionality for USD one billion loans might inflict serious pressure over the balance of payment and GDP growth in Bangladesh.

Conclusion

The IMF's loan that is to be provided through ECF programme might have a negative impact in Bangladesh economy. Bangladesh Bank has already phased out the interest rate ceiling following the IMF's conditionality in an effort to stabilise the inflationary situation and to eradicate the pressure on balance of payment. The country might face trouble in some areas like high inflation, slow remittance and pressure on balance of payment if IMF's prescriptions are implemented. If Bangladesh Bank allows a greater flexible exchange rate policy as a major requirement of IMF, the country would face a huge trade deficit. The export sector is also likely to face a difficult competitive edge with its current competitors. Moreover, the consumer welfare security might be constrained as a result of raising CNG and furnace oil prices and placing a new VAT regime. This would worsen the rising inequality level which is a major concern of the government.

The tariff structure of a country should be formulated according to its own economic nature and strength. Further deregulation of tariff regime may enhance the susceptibility of local industry as well as the trade balance. The IMF's prescriptions might restrict the policy space of the government for sustained economic growth.

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